

KOSRAE UTILITIES AUTHORITY

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2005 AND 2004

INDEPENDENT AUDITORS' REPORT

The Board of Directors
Kosrae Utilities Authority:

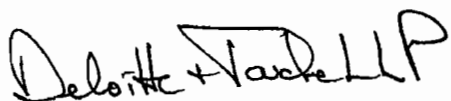
We have audited the accompanying statements of net assets of the Kosrae Utilities Authority, a component unit of the Kosrae State Government, as of September 30, 2005 and 2004, and the related statements of revenues, expenses and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Kosrae Utilities Authority management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Kosrae Utilities Authority's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements present fairly, in all material respects, the financial position of Kosrae Utilities Authority as of September 30, 2005 and 2004, and the changes in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The Management Discussion and Analysis on pages 2-4 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. The supplementary information is the responsibility of Kosrae Utilities Authority's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 1, 2006, on our consideration of the Kosrae Utilities Authority's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.



May 1, 2006

KOSRAE UTILITIES AUTHORITY

Management Discussion and Analysis Year Ended September 30, 2005

This section of the Kosrae Utilities Authority's (KUA) annual financial report presents the analysis of KUA's financial performance during the fiscal year ended September 30, 2005. Please read it in conjunction with the financial statements, which follows this section.

Kosrae Utilities Authority (KUA) was mandated by law in October 1993 as a semi-agency of the Kosrae State Government to assume the operation and responsibility of providing electric power services to the Island of Kosrae. KUA is governed by five (5) board members appointed by the Governor with the advice and consent of the State Legislature for a staggering term of 2 to 4 years.

KUA presently serves 1,652 customers. With no change in customer based from the previous operating year, the ratio remains the same at approximately 80% residential, 11% commercial, 6% Kosrae State Government, 2% non-Kosrae State Government and 1% industrial. With little or no economic growth on Kosrae, the energy sales ratio to various customer sectors is expected to continue for the next several years of operation, but should be reviewed annually since any changes in one customer class such as industrial or commercial can have positive or negative effect on future operating revenues.

As we had experienced last year, Fiscal Year 2005 was also a difficult and challenging year due to serious issues facing the operation. The issues encountered were increasing fuel costs, a continued decline of the kilowatt hour sales, the discontinuation of the U.S. energy grant subsidy, and that the current power rates are inadequate to cover the total cost of operation and the low return on investments. The electric revenues from existing power rates and fuel adjustment charges provide for approximately 68% of the total operating expenses with 7% non-operating revenues from OMIP/DOI and interest income from investment. The financial challenge is that KUA has continued to realize a revenue and expenditure gap of 25% during FY2005 in which reinstating the gradual rate increase schedule will be necessary to make up for the statement loss or it will be necessary to resort to a reduction of operating expenses to minimize the shortfall.

The following table summarizes the financial position and results of operation of Kosrae Utilities Authority for 2005 and 2004.

	<u>2005</u>	<u>2004</u>
Assets:		
Current assets	\$ 2,978,869	\$ 3,202,708
Utility plant, net	<u>4,509,386</u>	<u>4,657,656</u>
	\$ <u>7,488,255</u>	\$ <u>7,860,364</u>
Liabilities and Net Assets:		
Current liabilities	\$ 238,216	\$ 87,028
Net assets	<u>7,250,039</u>	<u>7,773,336</u>
	\$ <u>7,488,255</u>	\$ <u>7,860,364</u>
Revenue, Expenses and Changes in Net Assets:		
Operating revenues	\$ 1,459,830	\$ 1,143,063
Operating expenses	<u>2,144,252</u>	<u>1,837,847</u>
Net operating loss	<u>(684,422)</u>	<u>(694,784)</u>
Operating subsidies	92,637	223,812
Interest income	<u>68,488</u>	<u>44,439</u>
Total nonoperating revenue	<u>161,125</u>	<u>268,251</u>
Decrease in net assets	\$ <u>(523,297)</u>	\$ <u>(426,533)</u>

KOSRAE UTILITIES AUTHORITY

Management Discussion and Analysis
Year Ended September 30, 2005

FINANCIAL HIGHLIGHTS

Operating revenue from electricity sales increases by 28% with the fuel adjustment charge contributing largely to that effect. Electricity sales is composed of 23% Residential, 16% Kosrae State Government, 4% Non-Kosrae State Government, 5% Industrial, 17% Commercial, 31% Fuel Adjustment Charge and 4% Other operating income.

In spite of the increase in sales value, kilowatt hour volume still continued to decline every year as the users tend to minimize consumption realizing the increase in tariff plus a growing fuel adjustment charge added on for every kilowatt hour usage.

KUA's gradual tariff increase that started this fiscal year projecting to partially recover the loss of the Compact Energy Grant was temporarily suspended by the Board of Directors in the succeeding fiscal years.

Operating expenses rose by 16% with production fuel causing the increase. Fuel usage has decreased by about 2% in volume but due to the higher fuel cost, a big amount was expended during the year. From an average cost of \$1.30 per gallon in the previous year to \$1.96 per gallon this year, we experienced a huge growth in this account as it almost doubled against last year's figure. This trend is expected to go on as fuel prices purchased from Micronesia Petroleum Corporation continue to grow as affected by fuel prices in the world market. Depreciation expense on the other hand was reduced by about 14% as some assets were fully depreciated last year and none was provided in the current year.

Non-operating revenues are grants received from US DOI OMIP. An amount of \$101,340 was approved in September 23, 2005 by US DOI for staff training and purchase of additional prepayment meters with KUA contributing the same amount. Interest income represents earnings from bank saving accounts and time certificates of deposit from Bank of the FSM and an increase in the market value of KUA's investment portfolios managed by Bank of Hawaii and Salomon Smith Barney.

Current assets decreased by 7%. Cash collections from billings and cash power sales were not sufficient to sustain the overwhelming increase in operational expenses caused by the skyrocketing fuel cost. Time certificate of deposits from Bank of the FSM were liquidated to cover the short fall. Counterpart contributions to OMIP and KUA funded projects also added to expenditures. Gross receivables from electricity sales decreased slightly this year representing a higher collection rate, but such was not enough to support operations.

The Board of Directors approved Micronesia Petroleum Corporation's requests to advance \$200,000 within three months and offset against fuel delivery at a discounted price. The amount of prepayment outstanding as of September 30, 2005 is \$123,500.

Utility plant consists of Production Plant, Distribution Plant and General Plant in service net of accumulated depreciation. Production plant includes the 6 caterpillar generators ranging in size from 560KW to 1.65MW units that supply the power on the whole island and production vehicles and equipment. Distribution Plant consists of the distribution system approximately 41 miles of 13.8kv overhead conductor and underground feeder to the main airport, dock, tank farm and Pacific Tuna Industries fish plant. The distribution feeders originate from the outdoor substation outside the generating plant and serve the island load with three radial feeders that follow coastal roads to the south and north of the plant. General Plant is composed of the administration building, vehicles, fixtures and equipment.

KOSRAE UTILITIES AUTHORITY

Management Discussion and Analysis Year Ended September 30, 2005

A total project cost of \$929,001 for Pole Hardening the 13.8KV distribution system from power plant in Tofol to Utwe was approved by FEMA. Grant amount of \$696,751 were taken from FEMA-Hazard Mitigation Grant Program funds. KUA and Kosrae State matched the \$85,000 and \$147,250 respectively to complete the project. The actual work started in Fiscal Year 2006. Additional information concerning fixed assets is set forth in the notes to the financial statements.

Current liabilities include a \$200,000 line of credit note availed at Bank of the FSM and accruals of expenses. On August 2005, KUA was able to secure a line of credit at Bank of the FSM for a limit of \$500,000 with our time certificate of deposit on their hand serving as collateral. This was able to help KUA in defraying emergency disbursements especially on the purchased of materials in undertaking the Tofol to Utwe Pole Hardening Project while awaiting reimbursement from FEMA office.

Plan of Action for 2006.

1. Recommend to the KUA Board to take action to reinstate the gradual rate increase schedule over the next five years to gradually reduce the current revenues and expenditures gap.
2. Continue to reexamine the annual Budget and reduce unnecessary operating expenses and seek fuel supply options to reduce fuel cost.
3. Continue to pursue aggressive collection of arrears accounts by more than 25% and install more Cash Power Meters for advance payments of kilowatt hours used.
4. Adopt a KUA Investment Statement Policy for KUA investment funds with Citigroup Global Markets, Inc. to provide increased return on investments with low risks.
5. Continue to provide training opportunities to employees and improved skill level and knowledge to improve work performances and reduce costs.
6. Purchase a new CAT engine generator unit that provides an improved fuel efficiency and reduces fuel and maintenance cost.
7. Upgrade Primary distribution power lines to reduce line loss and loss revenues during forced outages and construct power extension lines to remote areas without power to increase customer base.
8. Improve accountability of KUA properties and procurement policies and procedures to reduce cost of materials and loss properties.
9. Seek and develop Renewable Energy Source Proposal that is viable for Kosrae to reduce dependency on fossil fuel and fuel cost to the operation.
10. Improve public relations to government officials and customers.

KOSRAE UTILITIES AUTHORITY

Statements of Net Assets September 30, 2005 and 2004

<u>ASSETS</u>	<u>2005</u>	<u>2004</u>
Current assets:		
Cash, available for operations	\$ 248,597	\$ 223,933
Investments	1,764,339	2,101,112
Accounts receivable, net	202,187	172,448
Receivable-OMIP	8	30,468
Receivable-FSM National Government Grant	7,785	7,785
Prepayments	142,073	2,310
Inventories (net of an obsolescence allowance of \$83,657 in 2005 and \$0 in 2004)	613,880	664,652
Total current assets	<u>2,978,869</u>	<u>3,202,708</u>
Utility plant:		
Electric plant in service	9,494,201	9,117,035
Construction work in progress	204,556	268,816
Less accumulated depreciation	<u>(5,189,371)</u>	<u>(4,728,195)</u>
Utility plant, net	<u>4,509,386</u>	<u>4,657,656</u>
	<u>\$ 7,488,255</u>	<u>\$ 7,860,364</u>
 <u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Short-term line of credit	\$ 200,000	\$ -
Accounts payable	4,310	55,078
Accrued taxes and other	13,584	14,817
Accrued interest payable	923	-
Accrued annual leave	<u>19,399</u>	<u>17,133</u>
Total liabilities	<u>238,216</u>	<u>87,028</u>
Commitments and contingency		
Net assets:		
Invested in capital assets	4,509,386	4,657,656
Unrestricted	<u>2,740,653</u>	<u>3,115,680</u>
Total net assets	<u>7,250,039</u>	<u>7,773,336</u>
	<u>\$ 7,488,255</u>	<u>\$ 7,860,364</u>

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY

Statements of Revenues, Expenses, and Changes in Net Assets Years Ended September 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Operating revenues:		
Electricity sales	\$ <u>1,459,830</u>	\$ <u>1,143,063</u>
Operating expenses:		
Production fuel	1,119,340	752,357
Depreciation	461,378	538,202
Salaries and wages	374,388	376,936
Administrative and general	128,343	118,737
Repair and maintenance	<u>60,803</u>	<u>51,615</u>
Total operating expenses	<u>2,144,252</u>	<u>1,837,847</u>
Loss from operations	<u>(684,422)</u>	<u>(694,784)</u>
Nonoperating revenues:		
Operating subsidies	92,637	223,812
Interest income	<u>68,488</u>	<u>44,439</u>
Total nonoperating revenues	<u>161,125</u>	<u>268,251</u>
Change in net assets	<u>(523,297)</u>	<u>(426,533)</u>
Net assets at beginning of year	<u>7,773,336</u>	<u>8,199,869</u>
Net assets at end of year	\$ <u><u>7,250,039</u></u>	\$ <u><u>7,773,336</u></u>

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY

Statements of Cash Flows Years Ended September 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Cash flows from operating activities:		
Cash received from customers	\$ 1,430,091	\$ 1,323,251
Cash paid to suppliers	(1,446,289)	(902,240)
Cash paid to employees	(374,388)	(385,633)
Net cash (used for) provided by operating activities	<u>(390,586)</u>	<u>35,378</u>
Cash flows from investing activities:		
(Increase) reduction in time certificates of deposit	336,773	(42,274)
Interest income	68,488	44,439
Net cash provided by investing activities	<u>405,261</u>	<u>2,165</u>
Cash flows from noncapital financing activities:		
Proceeds from short-term loan	200,000	-
Proceeds from operating grants	123,097	223,812
Net cash provided by noncapital financing activities	<u>323,097</u>	<u>223,812</u>
Cash flows from capital financing activities:		
Purchase of property, plant and equipment	(313,108)	(399,974)
Net cash used for capital financing activities	<u>(313,108)</u>	<u>(399,974)</u>
Net change in cash	24,664	(138,619)
Cash at beginning of year	223,933	362,552
Cash at end of year	<u>\$ 248,597</u>	<u>\$ 223,933</u>
Reconciliation of loss from operations to net cash (used for) provided by operating activities:		
Operating loss	\$ (684,422)	\$ (694,784)
Adjustments to reconcile operating loss to net cash provided by (used for) operating activities:		
Depreciation	461,378	538,202
(Increase) decrease in assets:		
Receivables	(29,739)	180,188
Prepayments	(139,763)	654
Inventories	50,772	38,080
Increase (decrease) in liabilities:		
Accounts payable	(50,768)	(18,265)
Accrued taxes and other liabilities	1,956	(8,697)
Net cash (used for) provided by operating activities	<u>\$ (390,586)</u>	<u>\$ 35,378</u>

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY

Notes to Financial Statements
September 30, 2005 and 2004

(1) Summary of Significant Accounting Policies

The accounting policies of Kosrae Utilities Authority (KUA) conform to accounting principles generally accepted in the United States of America as applicable to governmental entities, specifically proprietary funds. Governmental Accounting Standards Board (GASB) Statement No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting," requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principle Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. KUA has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

KUA has adopted GASB Statement No. 34, "Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments" (GASB 34) as amended by GASB Statement No. 37 and GASB Statement No. 38. GASB Statement No. 34 establishes standards for external financial reporting for state and local governments and requires that resources be classified for accounting and reporting purposes into the following four net asset categories:

- Invested in capital assets, net of related debt:
Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.
- Restricted:
 - Nonexpendable – Net assets subject to externally imposed stipulations that require KUA to maintain them permanently. For the years ended September 30, 2005 and 2004, KUA does not have nonexpendable restricted net assets.
 - Expendable – Net assets whose use by KUA is subject to externally imposed stipulations that can be fulfilled by actions of KUA pursuant to those stipulations or that expire by the passage of time.
- Unrestricted:
Net assets that are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action by management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

Basis of Accounting: All proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation of the fund are included in the statement of net assets.

The accrual basis of accounting is utilized by proprietary funds. Under this method, revenues are recorded when earned and expenses recorded at the time liabilities are incurred. Revenues are recorded as billed to customers on a monthly cycle billing basis. At the end of each month, unbilled revenues are accrued based on the most recent billing cycle.

General: KUA is a component unit of the Government of Kosrae. KUA commenced operations on October 1, 1993, with the assets and liabilities of the Division of Public Utilities of the Kosrae State Department of Public Works transferred as of that date.

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Notes to Financial Statements September 30, 2005 and 2004

(1) Summary of Significant Accounting Policies, Continued

Utility Plant: Utility plant assets were transferred from the Division of Public Utilities to KUA as of October 1, 1993 at the estimated net book value in the absence of documents to support cost. At September 30, 2005 and 2004, approximately 18 percent of utility plant transferred to KUA was stated at estimated cost. The net book value of the utility plant assets transferred was \$682,779 and \$850,602 as of September 30, 2005 and 2004, respectively. KUA capitalizes individual items that have a cost in excess of \$1,000 and an estimated useful life of more than one year.

Depreciation: Depreciation is computed using the straight-line method over the estimated useful lives of the assets (3 - 40 years for plant assets). Depreciation expense for 2005 and 2004 was approximately six percent of the cost of depreciable properties.

Annual and Sick Leave: Earned but unused annual leave is paid to employees upon termination of their employment. Accordingly, KUA accrues these benefits in the period earned. It is the policy of KUA to record the cost of sick leave when leave is actually taken and a liability is actually incurred.

Revenues: Sales of electricity are recorded as billed to customers on a monthly billing cycle basis.

Federal Grants and Subsidies: KUA receives federal grants as a subrecipient from Kosrae State in addition to Kosrae State Legislature appropriated subsidies, FSM National Congress appropriated subsidies, and matching funds for federal programs as required.

Inventory: Inventories are carried at the lower of cost, using average cost, or market value. An allowance for obsolescence is provided based on periodic management assessment.

Cash: For purposes of the statements of net assets and of cash flows, cash includes cash on hand, cash in bank checking and savings accounts, time certificates of deposit with initial maturities of three months or less and money market funds. Time certificates of deposit with initial maturities greater than three months are separately classified as investments. Of cash balances at September 30, 2005 and 2004, \$200,000 is subject to Federal Deposit Insurance Corp. (FDIC) coverage, with the remaining balance exceeding insurable limits. KUA does not require collateralization of its deposits. Accordingly, these deposits are exposed to custodial credit risk. Therefore, the amounts which exceed FDIC limits are characterized as uncollateralized. There are immaterial differences between the cash account book and bank balances.

Restricted Investments: As of September 30, 2005, \$632,848 (\$1,025,869 in 2004) in time certificates of deposit placed with local banks with annual interest rates ranging from .9% to 3% has been internally reserved for maintenance, capital improvements and work in progress.

Investments: Investments and related investment earnings are recorded at fair value. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

GASB Statement No. 3 previously required government entities to present investment risks in terms of whether the investments fell into the following categories:

Category 1 Investments that are insured or registered, or securities held by KUA or its agent in KUA's name;

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Notes to Financial Statements
September 30, 2005 and 2004

(1) Summary of Significant Accounting Policies, Continued

Investments, Continued

Category 2 Investments that are uninsured and unregistered for which the securities are held by the counterparty's trust department or agent in KUA's name; or

Category 3 Investments that are uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in KUA's name.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for investments falling into categories 1 and 2, and provided for disclosure requirements addressing other common risks of investments such as credit risk, interest rate risk, concentration of credit risk, and foreign currency risk. GASB Statement No. 40 did retain and expand the element of custodial credit risk in GASB Statement No. 3.

As of September 30, 2005 and 2004, investments at fair value comprise the following:

	<u>2005</u>	<u>2004</u>
Time certificates of deposit	\$ 632,848	\$ 1,025,879
Money market funds	526,811	522,228
Common stock	422,885	390,698
Government bonds	<u>181,795</u>	<u>162,307</u>
	<u>\$ 1,764,339</u>	<u>\$ 2,101,112</u>

As of September 30, 2005, the composition and maturities of government bonds are as follows:

<u>Investment Type</u>	<u>Investment Maturities (in years)</u>			
	<u>Fair Value</u>	<u>Less than 1</u>	<u>1-5</u>	<u>5-10</u>
U.S Treasury obligations	\$ 111,477	\$ 42,146	\$ 27,984	\$ 41,347
U.S. Government agency obligations	<u>70,318</u>	<u>-</u>	<u>70,318</u>	<u>-</u>
	<u>\$ 181,795</u>	<u>\$ 42,146</u>	<u>\$ 98,302</u>	<u>\$ 41,347</u>

As of September 30, 2004, the composition and maturities of government bonds are as follows:

<u>Investment Type</u>	<u>Investment Maturities (in years)</u>			
	<u>Fair Value</u>	<u>Less than 1</u>	<u>1-5</u>	<u>5-10</u>
U.S Treasury obligations	\$ 112,094	\$ -	\$ 112,094	\$ -
U.S. Government agency obligations	<u>50,213</u>	<u>15,211</u>	<u>14,883</u>	<u>20,119</u>
	<u>\$ 162,307</u>	<u>\$ 15,211</u>	<u>\$ 126,977</u>	<u>\$ 20,119</u>

KOSRAE UTILITIES AUTHORITY

Notes to Financial Statements
September 30, 2005 and 2004

(1) Summary of Significant Accounting Policies, Continued

Investments, Continued

Credit risk for investments is the risk that an issuer or other counterparty to an investment will not fulfill its obligations.

KUA's exposure to credit risk at September 30, 2005, was as follows:

<u>Moody's Rating</u>	<u>Total</u>	<u>Domestic</u>
AAA	\$ <u>181,795</u>	\$ <u>181,795</u>
Total credit risk debt securities	\$ <u>181,795</u>	\$ <u>181,795</u>

KUA's exposure to credit risk at September 30, 2004, was as follows:

<u>Moody's Rating</u>	<u>Total</u>	<u>Domestic</u>
AAA	\$ <u>162,307</u>	\$ <u>162,307</u>
Total credit risk debt securities	\$ <u>162,307</u>	\$ <u>162,307</u>

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, KUA will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. KUA's investments are held and administered by trustees. Based on negotiated trust and custody contracts, all of these investments were held in KUA's name by KUA's custodial financial institutions at September 30, 2005 and 2004.

Concentration of credit risk for investments is the risk of loss attributed to the magnitude of an entity's investment in a single issuer. GASB Statement No. 40 requires disclosure by issuer and amount of investments in any one issuer that represents five percent (5%) or more of total investments for KUA. As of September 30, 2005, 6.3% of its investments are in U.S. Treasuries. As of September 30, 2004, KUA's investment in U.S. Treasuries constituted 5.3% of its total investments.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments. KUA does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

New Accounting Standards: For fiscal year 2005, KUA implemented GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, (an amendment of GASB Statement No. 3) and GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. Implementation of the statements had had no material impact on the 2005 financial statements.

KOSRAE UTILITIES AUTHORITY

Notes to Financial Statements
September 30, 2005 and 2004

(1) Summary of Significant Accounting Policies, Continued

Management Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(2) Utility Plant

Utility plant consists of the following at September 30, 2005 and 2004:

	<u>Estimated Useful Lives</u>	<u>Balance at October 1, 2004</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Balance at September 30, 2005</u>
<u>Depreciable assets:</u>					
Production plant	5 to 40 years	\$ 4,583,371	\$ 5,148	\$ -	\$ 4,588,519
Distribution plant	5 to 30 years	4,026,150	368,758	(917)	4,393,991
General plant	3 to 20 years	<u>507,514</u>	<u>4,177</u>	<u>-</u>	<u>511,691</u>
Total electric plant in service		9,117,035	378,083	(917)	9,494,201
Less accumulated depreciation		<u>(4,728,195)</u>	<u>(461,378)</u>	<u>202</u>	<u>(5,189,371)</u>
		4,388,840	(83,295)	(715)	4,304,830
<u>Non-depreciable assets:</u>					
Work in progress		<u>268,816</u>	<u>294,987</u>	<u>(359,247)</u>	<u>204,556</u>
Electric plant in service, net		\$ <u>4,657,656</u>	\$ <u>211,692</u>	\$ <u>(359,962)</u>	\$ <u>4,509,386</u>
	<u>Estimated Useful Lives</u>	<u>Balance at October 1, 2003</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Balance at September 30, 2004</u>
<u>Depreciable assets:</u>					
Production plant	5 to 40 years	\$ 4,372,880	\$ 210,491	\$ -	\$ 4,583,371
Distribution plant	5 to 30 years	3,558,274	470,055	(2,179)	4,026,150
General plant	3 to 20 years	<u>500,600</u>	<u>6,914</u>	<u>-</u>	<u>507,514</u>
Total electric plant in service		8,431,754	687,460	(2,179)	9,117,035
Less accumulated depreciation		<u>(4,189,992)</u>	<u>(538,203)</u>	<u>-</u>	<u>(4,728,195)</u>
		4,241,762	149,257	(2,179)	4,388,840
<u>Non-depreciable assets:</u>					
Work in progress		<u>554,122</u>	<u>118,901</u>	<u>(404,207)</u>	<u>268,816</u>
Electric plant in service, net		\$ <u>4,795,884</u>	\$ <u>268,158</u>	\$ <u>(406,386)</u>	\$ <u>4,657,656</u>

KOSRAE UTILITIES AUTHORITY

Notes to Financial Statements
September 30, 2005 and 2004

(3) Accounts Receivable

Accounts receivable at September 30, 2005 and 2004, are summarized as follows:

	<u>2005</u>	<u>2004</u>
Residential	\$ 62,971	\$ 73,004
Commercial	148,704	137,203
Government	<u>69,569</u>	<u>157,709</u>
	281,244	367,916
Other	<u>132,523</u>	<u>99,768</u>
	413,767	467,684
Less allowance for doubtful receivables	<u>(211,580)</u>	<u>(295,236)</u>
	\$ <u>202,187</u>	\$ <u>172,448</u>

All of KUA's accounts receivable are with customers and government agencies based in Kosrae.

(4) Operating Subsidies

Contributions for the years ended September 30, 2005 and 2004 are as follows:

	<u>2005</u>	<u>2004</u>
U.S. Department of the Interior operations and maintenance improvement program (OMIP) grants	\$ 92,637	\$ 153,812
Kosrae State Government	<u>-</u>	<u>70,000</u>
	\$ <u>92,637</u>	\$ <u>223,812</u>

(5) Commitments

Net assets at September 30, 2005 has been appropriated in the amount of \$1,016,919 for repair and maintenance and capital improvement projects. This process will continue in fiscal year 2006 with a total of \$25,000 being further appropriated on a quarterly basis from net assets for this purpose.

(6) Risk Management

KUA carries insurance to cover its potential risks from fire on its building and the contents and full coverage on property damage. KUA is substantially self-insured for all other risks. Management is of the opinion that no material losses have been sustained as a result of this practice.

(7) Retirement Plan

In 2004, KUA initiated a retirement plan covering all employees with at least one year of service that is modeled after a U.S. defined contribution plan. Vesting occurs upon plan entry. Employee contributions can be from 1% to 15% of earnings with a 50% match by KUA up to 5% of employee compensation. During the years ended September 30, 2005 and 2004, KUA incurred an expense of \$8,005 and \$2,452, respectively, for such match.

KOSRAE UTILITIES AUTHORITY

Notes to Financial Statements
September 30, 2005 and 2004

(8) Related Parties

KUA is affiliated with Kosrae State and its component units. All production fuel is purchased from a Kosrae State component unit. All KUA services to Kosrae State and its component units are provided on the same basis as provided to unrelated parties.

(9) Short-Term Line of Credit

From October 1, 2004 through August 2005, KUA maintained a \$200,000 bank line of credit that was not utilized. In August 2005, KUA increased the line to \$500,000. The notes are due in ninety day terms, interest is at 4%, and the line is collateralized by time certificates of deposit of \$632,848. One drawdown of \$200,000 was made and is outstanding against the line as of September 30, 2005, which was used to obtain fuel at a discount.

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND COMPLIANCE AND OTHER MATTERS BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

The Board of Directors
Kosrae Utilities Authority:

We have audited the financial statements of the Kosrae Utilities Authority (KUA), as of and for the year ended September 30, 2005, and have issued our report thereon dated May 1, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered KUA's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect KUA's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether KUA's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

This report is intended for the information of the Board of Directors and management of KUA and the cognizant audit and other federal agencies and is not intended to be, and should not be, used by anyone other than those specified parties.

Deloitte + Stach LLP

May 1, 2006